Architects of Stability? International Cooperation Among Financial Supervisors

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My comments would have been better informed if this occasion had been deferred for a year, or two.

Basle	French spelling
Basel	German spelling

English, and Swiss, have used either version. In UK, Basle used to predominate, but now Basel has become more common, especially when talking about Basel II.

Briefly discuss three issues:-

1. Does consolidation, via mergers, raise extra problems of ‘too big to fail’?

2. Were Basel I and II driven by the interests of large banks? How far were the regulators ‘captured’?

3. The changing structure of banking supervision, and of crisis management.

(1) Too big to fail

Kapstein emphasizes, p. 28, that mergers have increasingly made banks ‘too big to fail’.

But banks have typically been too big to close for decades. Liquidation (in USA by FDIC, or elsewhere) is very rare. What matters for incentives is not the threat of closure, but the threat of sacking for managers and of loss of equity values, (for both managers and shareholders).

The growing danger is of becoming ‘too complex to fail’. LTCM story. Analysed by Herring.

Indeed ‘too big to fail’ can be turned on its head; big international banks headquartered in small countries may now become ‘too big to rescue’.

(2) Capture?

At various points, (e.g. pp 2/3, 6, 32, 34/5), Kapstein suggests that the CARs in Basel I and II were driven by the desire of large banks (especially in the USA and UK) for a competitive level-playing-field, and there is a hint even that the large banks were consciously shaping the regulation to give themselves a competitive advantage vis-à-vis small banks, (both domestically and in host countries).

In my view this goes too far. Regulators had their own initial reasons for wanting to raise regulatory capital (Basel I) and then to relate it more closely to economic capital (Basel II). Problem was that domestic banks would not accept higher CARs without being protected from foreign bank competition, as Kapstein correctly states on p. 19.

I agree that regulation has had comparative advantages for large, international banks, but this is because of BCBS search for <u>best practice</u>, <u>not capture</u>.

(3) <u>Organisational Structure of Banking Supervision and Crisis Management</u>

A) Supervisory responsibilities

Kapstein, p. 6,

‘many central banks have, in recent years, developed a capacity to monitor the health of their nation’s overall financial system, expanding their oversight and supervisory responsibilities well beyond commercial banks and payments systems.’

But, rise of specialised Financial Services Authorities have been <u>shrinking</u> CB supervisory responsibilities. CBs retain mandate for “overall systemic stability”, but far from clear what that means in the absence of a supervisory role.

B) Lender of Last Resort

Kapstein, p. 29,
"given the size of these [banking] institutions, the lender of last resort function might not be adequately performed by the central bank, and fiscal policy instruments would be required instead."

But a central bank can always create liquidity without limit (as at 9/11). What it has never been able to create is fresh capital. Thus no c.b. has been able to handle a serious solvency crisis by itself. What is new is that outside support for the c.b. at times of (solvency) crisis has already swung from banking clubs to the government.

C) Crisis Management

Kapstein, p. 36,
"during future crises it is inevitable that there will be a demand by financial agents for closer cooperation not just between central bankers and financial supervisors, but perhaps with elected officials as well."

But this happened 20 years ago in UK when BoE tried to rescue Johnson Matthey Bankers without recourse to HMT. Procedure now institutionalised in MOU (1997) setting up Tripartite Standing Committee of HMT, FSA, BoE. Similar developments in many other countries.

This is OK within countries, but problematical between countries. And how will greater role of Ministries of Finance affect BCBS?